China: Priced-in Pessimism Could Provide Opportunity for Value Investors

No one likes chaos in markets, but as Oaktree co-chairman Howard Marks wrote recently, sometimes chaos "fuels emotional selling that allows us to access the greatest bargains."[1] We believe that's the case in China, where strong economic headwinds and excessive investor pessimism have pummeled equities. We believe this pessimism is overblown and could create real opportunities for value investors.

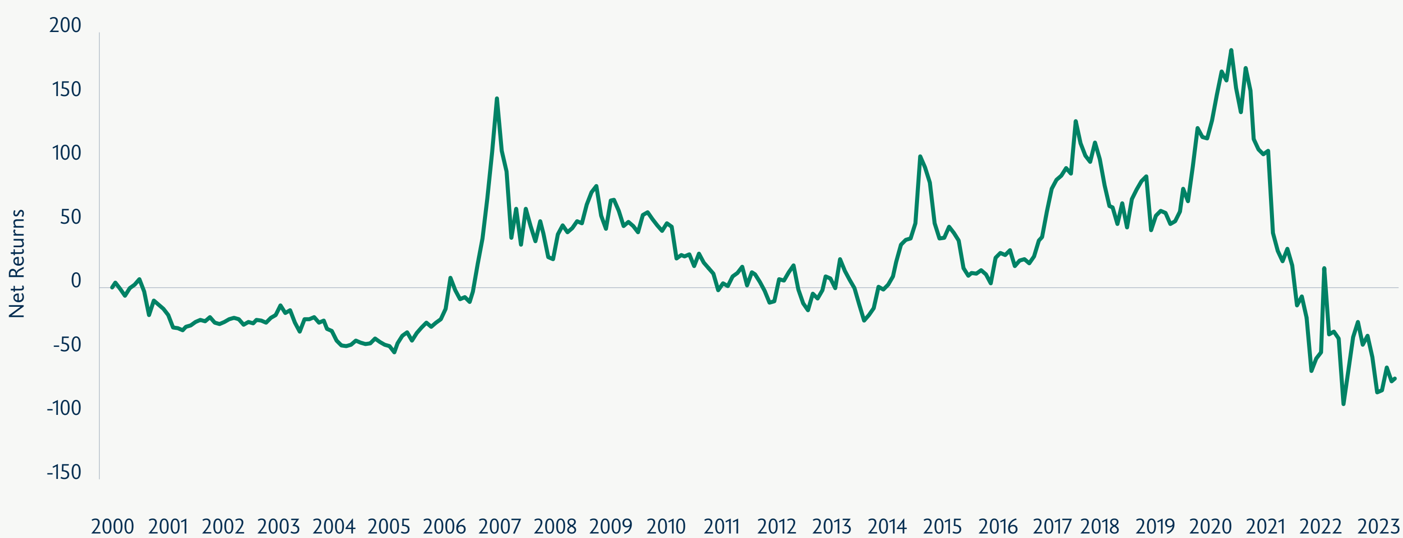
In his *Taking the Temperature* memo from July, Marks highlighted some key tenets of Oaktree's approach to value investing that we believe apply to Chinese equities: understand that cycles stem from "excesses and corrections"; watch for moments when investors are overly optimistic or pessimistic that things can only get better or worse; remember that amid extreme optimism or pessimism the secret to making money lies in contrarianism, not in conformity; and, finally, resist your own emotionality.

Chinese Equities Are Underperforming Other Asian Markets

Few investors would dispute that Chinese equities are mired in extreme pessimism. China is struggling with a slowing economy and geopolitical tensions while also grappling with post-pandemic supply chain challenges. All this has caused many investors to dump their Chinese stocks, which are now underperforming Asia ex-Japan by their widest margin in years (**Figure 1**).

Figure 1: Chinese Equities Are Underperforming Other Asian Markets by the Widest Margin in History

Performance of MSCI China Index Relative to MSCI AC Asia Pacific Ex-Japan Index



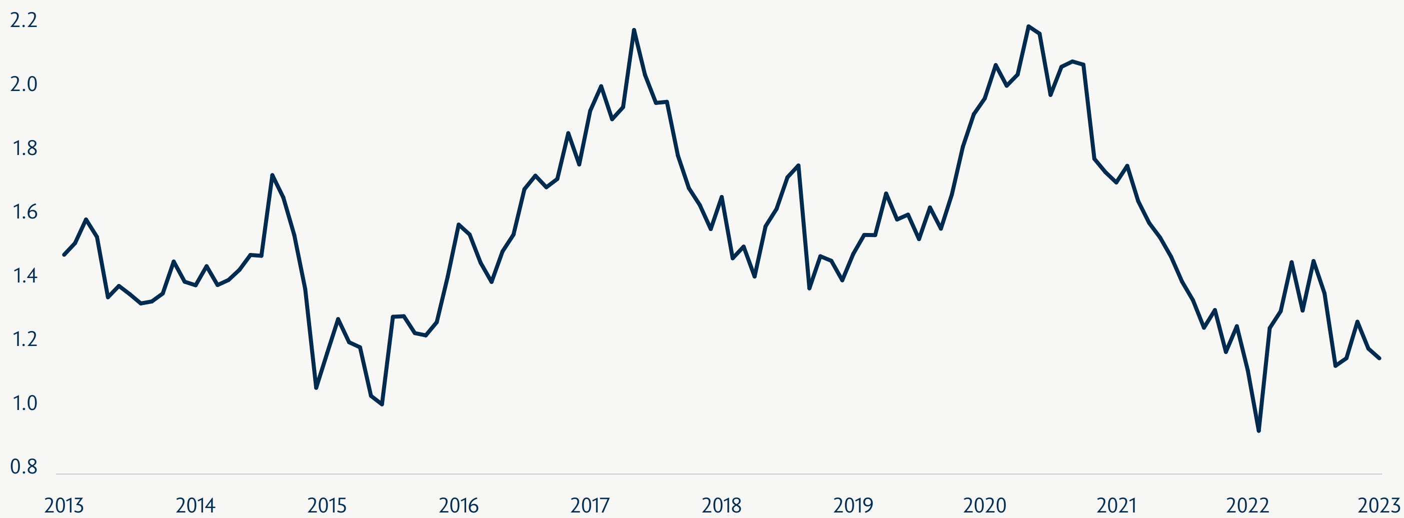
Source: MSCI; data as of September 30, 2023. The indexes are unmanaged and cannot be purchased directly by investors. Index performance is shown for illustrative purposes only and does not predict or depict the performance of any investment.

Buying Chinese Stocks with Strong Fundamentals at a Discount

We believe Chinese equities are pricing in more than today's negative news but also an extremely pessimistic outlook that we do not share. At Oaktree, we define value investing as quantifying what something is intrinsically worth, based primarily on its fundamental cash-flow-generating capabilities, and buying when prices represent a meaningful discount from that value. With Chinese equity valuations close to 10-year lows (**Figure 2**), we believe value investors could now acquire assets at a significant discount to their fundamental value.

Figure 2: Low Chinese Equity Valuations Suggest Significant Discount Vs. Fundamental Value

Price-to-Book Value of MSCI China Index



Source: Bloomberg; data as of September 30, 2023.

Price-to-Book Value equates to the market value of a company's share price over its book value of equity. The book value of equity is the value of a company's assets expressed on the balance sheet.

The Case for Chinese Equities

We see long-term fundamental value in Chinese equities for two reasons:

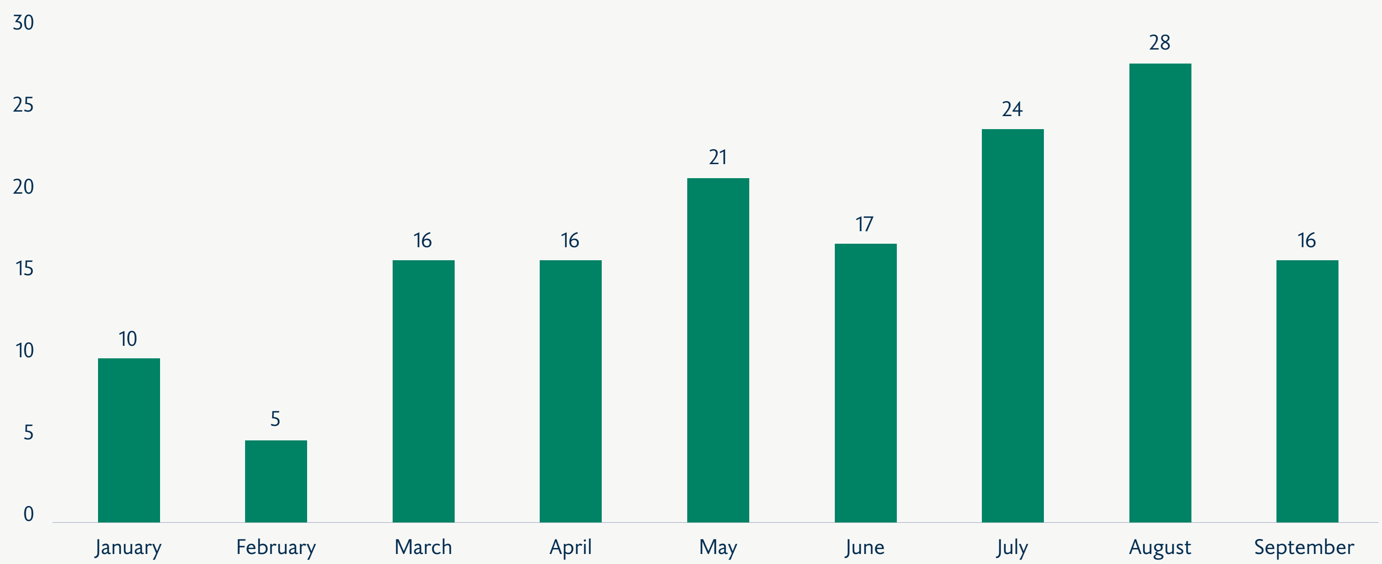
1. After a period of relative inaction, Beijing has begun stimulating the economy to chart a more sustainable trajectory.
2. We believe pessimists do not fully appreciate China's crucial role in the global economy and how difficult it would be to diminish its importance in corporate supply chains.

In recent years there has been a proliferation of bad news involving China, including concerns about Beijing's challenges in countering population shrinkage and dealing with economic growth imbalances and weak domestic consumption. Furthermore, recent efforts to improve the education and property sectors and other economic reforms will take time to pay dividends, making for a challenging period of adjustment ahead.

Nevertheless, Beijing has ramped up policy actions, from loosening monetary policy to implementing targeted stimulus to stabilize the property market and taking action to improve sentiment. While many of these measures have been modest and not particularly headline-friendly, we have been encouraged by the steady, building momentum of policy support (**Figure 3**). That's especially true because many of these actions are intended to directly benefit Chinese companies, many of which have healthy balance sheets and strong cash flows after years of cost-cutting and capital discipline.

Figure 3: Beijing Has Announced a Steady Drumbeat of Policy Actions Throughout 2023

Announced Policy Measures



Source: JP Morgan; data as of September 30, 2023.

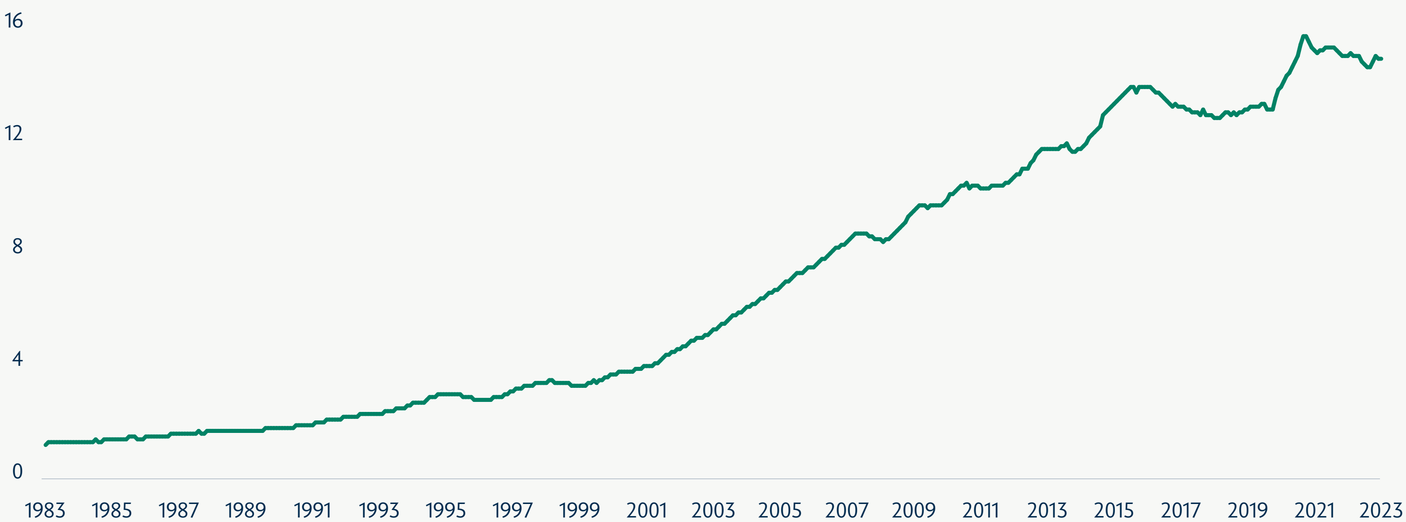
China Should Remain Integral to Global Supply Chains

Despite all the chatter since the global pandemic about reducing the reliance on China within global supply chains, the country still accounts for about 15% of global exports (**Figure 4**). Although that is modestly off its 2021 peak, we believe China remains a critical manufacturing hub and an integral component of global supply chains, limiting the extent of any "decoupling" in the near to intermediate term.

Indeed, China's role in global supply chains could become even more important as the push for a more sustainable global economy gathers pace. China's vast stores of the raw materials needed to produce increasingly important renewable products—commodities such as copper, lithium, cobalt and rare earth metals—will make it a vital player in the effort to power the global energy transition.

Figure 4: Despite Supply Chain Talk, China's Share of World Exports Remains Near Record Highs

(%, annualized)



Source: International Monetary Fund, Datastream; data as of June 15, 2023.

The Patient May Triumph

Chaotic times can trigger emotional selling by investors. However, during this troubling time for Chinese equity valuations, we believe investors should remain patient and committed to their investment process. With careful due diligence and selectivity, value investors could generate strong returns by buying shares in high-quality, fundamentally sound Chinese companies at discounted prices.

ENDNOTE

[1] Memos From Howard Marks: *Taking the Temperature*, Oaktree Capital Management, July 10, 2023.

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